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SUBJECT: KAZAKHSTAN: GOVERNMENT MOVES SWIFTLY TO STABILIZE BANKING SECTOR (PART 1 OF 3)

¶1. (U) Sensitive but unclassified. Not for public Internet.

¶2. (U) This is the first in a three-part series analyzing Kazakhstan's response to the global financial crisis.

¶3. (SBU) SUMMARY: On October 13, President Nazarbayev announced a series of sweeping measures to be enacted by the Government of Kazakhstan in response to the global financial crisis. To ensure the stability of Kazakhstani financial markets, these measures include the accelerated establishment and implementation of the Asset Stabilization Fund (ASF), the merger of the two largest asset generating and wealth distributing state holding companies Samruk and Kazyna, the Law on Financial Stability (since adopted), and the government's intention to purchase 25% equity stakes of the leading four banks sometime in the coming months. Across the board, expectations are that the coming year will be more difficult than the current one. Some officials remain hopeful that 2010 will mark the beginning of the recovery of the banking sector, while others believe it may take significantly longer. On average, government officials expect a full recovery to take four to five years. For now, with moderate pressure from the government's regulatory agencies, Kazakhstan's largest banks prepare to enter into a more intimate relationship with the state via Samruk-Kazyna in a unified fiscal front for reasons of self preservation and economic stability. END SUMMARY.

KAZAKHSTAN WELL-PREPARED FOR CRISIS MANAGEMENT

¶4. (SBU) In comparison to the scale and severity of the financial crisis in other parts of the globe, the situation in Kazakhstan does not appear as bleak. While European Bank for Reconstruction and Development (EBRD) Principal Banker in Almaty Mehmet Ilkin echoed the industry consensus that Kazakhstan's financial institutions will not regain access to international credit markets soon, the government has repeatedly pledged not to allow any of its major banks to fail and is taking a notably robust course of action. According to Citibank-Kazakhstan CEO Dan Connelly, who noted that Kazakhstan's banking crisis began in August 2007, "Kazakhstan got a

head start on this, and did everything everyone hoped they would do." He added that as with other impacted industries and markets, some consolidation can be expected in the banking sector, but not to a degree that will cause any negative or long-lasting systemic impact.

LOCAL BANKS FORECAST MODEST GROWTH

¶5. (SBU) True to form, Bank Turan Alem (BTA) Board Member George Iosifyan's outlook was largely positive, noting that trade relations would continue to develop, and that growth potential still existed, given that Kazakhstan, with vast oil and gas deposits, still has "what the world needs." BTA grew 16% in the first quarter of 2008, and despite increasing threats of global stagnation, the Kazakhstani economy is still expected to experience 3-5% annual economic growth (4% GDP). Iosifyan expects modest but continued growth in the Kazakhstani banking sector in 2009 of approximately 7-9%. Officials at KazKommertsBank (KKB), BTA and Halyk Bank shared a positive outlook for recovery in the construction and real estate sectors as early as 2010, because of delayed demand for residential property.

INTERNATIONAL BANKS AND RATINGS AGENCIES LESS OPTIMISTIC

¶6. (SBU) Independent financial institutions such as Citibank and the EBRD are not as optimistic as local banks, but do believe there is significant room for growth and investment in the Kazakhstani agricultural sector and related industries such as food processing and fertilizer production. However, recovery and growth in Kazakhstani markets remain largely connected to U.S. market recovery, and the price for commodities such as oil, which at current prices below $50 is already creating havoc for Kazakhstani budgeting agencies. Despite the government's actions, ratings



agencies such as Fitch maintain a more pessimistic outlook. On November 10, Fitch downgraded Kazakhstan's sovereign rating to BBB- and is keeping the securities on its watchlist. Standard and Poors reported "no tangible signs of banking sector recovery" and believe that the resolution of the problems will be "a lengthy process."

GOVERNMENT EAGER TO PUCHASE SHARES OF MAJOR BANKS

¶7. (SBU) The primary thrust of the government's stabilization efforts will be the infusion of approximately $5 billion in funds into the banking sector. Funds derived from the National (Oil) Fund will be used to purchase equity stakes in the country's four largest banks. The government has been actively soliciting input into this program from representatives of the World Bank, the IMF, and EBRD and is now taking concrete steps to put the plan in motion. Specific details, including limitations on the use of funds, are still being negotiated between the governmental regulatory agencies and the individual banks. An announcement detailing specific facets of the government stabilization efforts will be made on November 25 in accordance with a presidential decree. This may or may not include details on specific arrangements made between the banks and the government.

PURCHASE WILL AFFORD VOTING RIGHTS

¶8. (SBU) According to the Ministry of Finance, funds will be allocated from the National (Oil) Fund to Samruk-Kazyna, which will in turn purchase up to a 25% equity stake in four of the nation's top banks: Alliance Bank, Halyk Bank, BTA (formerly known as Bank Turan Alem), and KKB. This equity may be in the form of common shares, preferred shares (subject to preemptive rights held by majority shareholders) and possibly additional subordinated debt. The specific terms of the purchases remain to be determined, but it is clear that 25% ownership will afford the government voting rights in the corporate governance of the banks. (NOTE: Sources at EBRD-Almaty indicate ownership could exceed 30% depending on arrangements. END NOTE.) Critics, such as EBRD Senior Banker and Acting Head of the Representative office in Astana Ulf Hindstrom question the motivation of the government, asking whether or not it is moving to consolidate control over the financial sector by nationalizing a portion of the banking industry. But most

Kazakhstani banking representatives, including Chairman of the Board at BCC Vladislav Lee and Deputy Chairman of Astana Finance Yerzhan Tumabekov expressed optimism regarding the government's new role in the industry. According to Citibank's Connelly, participation may or may not necessarily be in the shareholders' interests for certain banks, and some banks may have been pressured into participation. However, he is convinced that the government does not want to become a long-term player in the banking industry and cautioned, "Don't consider this a land grab to nationalize the banking sector." Kazyna General Manager Marat Aitenov said that Kazyna does not want to control the banks, but rather wants to participate in the strategic decision-making process to ensure the well-being of the institutions and the greater economy.

BTA TO GET LION'S SHARE

¶9. (SBU) Early indications are that Alliance Bank will receive $370 million, Halyk Bank $300 million, KKB $500 million, and BTA the lion's share of $2.3 billion. Senior bank officials expect equity transfers to begin at any time. BTA is slated to receive by far the largest portion of the stabilization package, a fact BTA Board Member Iosifyan justified by noting that it is the largest bank in Kazakhstan with a net value of over $3.9 billion. He also said that BTA is significantly over-extended in international markets, with over $2.5 billion due in repayments in 2009 including Eurobonds and syndicated loans. BTA is confident that it would be able to make these payments, but not without cutting back on domestic lending practices. According to Iosifyan, the Government of Kazakhstan



wants to support BTA's bid to become one of the world's top 10 financial institutions and take advantage of its 30% share of the Kazakhstani credit market to serve as a platform for credit distribution of to small and medium enterprises. Iosifyan sees the developing strategic partnership as "more pro than con" noting that he does not expect the Financial Supervision Agency (FSA) to get involved in daily management as long as BTA does "not add more debt to our balance sheets." The government will now be BTA's largest single shareholder, but Iosifyan does not expect any changes to the leadership structure. He half-jokingly added, "If the government representative is professional, there should not be many changes."

¶10. (SBU) In addition to the four banks scheduled to participate in the government purchase program, two partially foreign-owned banks have been selected as potential participants. On November 3, the head of the Kazakhstani Financial Supervision Agency Yelena Bakhmutova publicly called for both the 5th and 6th ranked banks, ATF-Uni Credit Bank and Bank Center Credit (partly owned by the South Korean Kookmin Bank), to accept the government's offer. ATF has not committed to participating in the stabilization program, although International Department Director Maxim Utepov did admit to Econoff that the bank was receiving some pressure directly from the Prime Minister's Office to accept, which would he said would ultimately be up to the shareholders to decide. According to Vladislav Lee, Chairman of the Board of BCC, which appears intent on accepting the offer, should all six banks participate in the program, they would collectively represent approximately 95% of the Kazakhstani banking sector.

MOVE SEEN AS TEMPORARY - POSSIBLY TO PROTECT PRIVATE INTERESTS

¶11. (SBU) Most industry representatives see these steps as only temporary measures. According to current plans, the government will most likely keep its shares for a minimum of three years, with an option to extend for an additional two years. Deputy Governor of the National Bank of Kazakhstan Medet Sartbayev confirmed that this is "not done to control the banks" and emphasized that "the government will sell back the shares." Despite growing confidence in the government's program to shore up the banking sector in response to worsening global markets, some experts wonder if the underlying sense of urgency is not being driven by the private interests of politically exposed individuals. (NOTE: Timur Kulibayev is the largest shareholder of Halyk Bank and according to EBRD officials, it is highly likely the interests of the president himself are represented in BTA. END NOTE). Regarding BTA, Principle Banker at EBRD-Almaty Mehmet Ilkin remarked that current

bank president "Ablyazov himself is not that powerful." EBRD's primary concern, according to Ulf Hindstrom, is that ultimately the government may want to influence where banks are making their investments. (NOTE: The EBRD will not work with either Nurbank or Halyk Bank because of their political exposure. END NOTE).

LAW STRONGLY ENCOURAGES PARTICIPATION

¶12. (SBU) The government's support to the banking sector is being carried out in the larger context of a newly adopted set of amendments to ten laws which govern the banking system, pensions, insurance, joint stock companies and the stock exchange, and portions of the criminal code. Signed into law by the president on October 23, the collective package of amendments is now referred to as the Law on the Sustainability of the Financial System. The Law enables increased regulatory oversight over the financial sector, as well as emergency powers to be assumed by the government in the event of a perceived financial crisis. It also increases the maximum level of deposit insurance from 700,000 to 5 million KZT, significantly increasing the government's role in guaranteeing the savings of Kazakhstani citizens.

LAW EMPOWERS FSA TO INTERVENE AS DESIRED



¶13. (SBU) To prevent the failure of banks and other financial institutions, representatives of the FSA now have the right to observe the executive and management boards of banks, but without interference in their operation. Indeed, many banks now have designated work space for rotating representatives of the FSA. In the event that deterioration, such as an encroaching violation of capital adequacy ratio, is detected, the FSA can demand an emergency action plan from the bank to ensure its stability. If this plan is not deemed satisfactory, the FSA may assume sweeping authority, including the right to make changes to the organizational structure, limiting work with deposits, ceasing distribution of dividends, and suspension of any or all necessary banking operations as required. (NOTE: Previous laws required violations of established ratios prior to intervention. Now the FSA need only detect a "deterioration" to intervene. END NOTE.)

¶14. (SBU) Should preventative measures fail, or should the FSA not detect deteriorations in time to take action, provisions are now made for the prosecution of management and direct take-over of institutions. These measures include criminal proceedings against the heads of financial institutions who either deliberately or through inactivity allow bankruptcy or the forced liquidation of a bank. In other words, bank presidents could be held criminally liable for bank failure. The law also allows the government to buy out the stocks of a bank, thereby taking control of the institution for one-year increments, in the event of a single violation of regulations governing capital adequacy ratios and/or liquidity ratios.

¶15. (SBU) Officially, there is no connection between the adoption of the amendments and the rumored agreement of the nation's top six banks to the stabilization program. According to EBRD's Ulf Hindstrom, the banks "become offended if you even suggest they are being forced into this arrangement."

¶16. (SBU) COMMENT: The government is clearly anxious to solidify its participation in the strategic management of the country's six largest banks through the purchase of 25% equity stakes. While the measure is marketed officially as a temporary intervention, some concerns remain about the government's long-term aspirations as it makes concrete moves to partially nationalize the private financial sector, and perhaps in the future direct their resources towards politically motivated causes. END COMMENT.

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